

Theme D: Bargaining

(see McMillan Ch. 5)

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The interesting question is:

What are the sources of bargaining strength?

1. A Bargaining Game

In the simplest business deal, the buyer (Burt) and the seller (Sally) bargain over the price of an object, such as a used car.

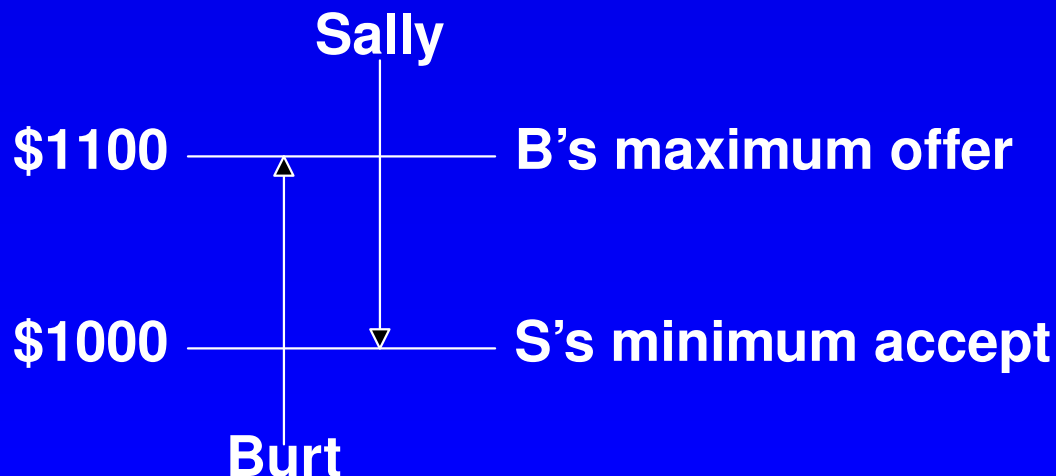
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Similar to labour/management negotiations, in essence.

e.g. If Sally knows the most Burt would be willing to pay (\$1100) and Burt knows the value to Sally of keeping the car (\$1000), then a deal is struck (efficient outcome) if the final price is in the range \$1000–\$1100



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Sally must conjecture what the highest price Burt will pay is;

Burt must conjecture what the lowest price Sally will accept is.

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e.g. What if Sally asks for, say, \$73.21?

- If Burt believes that this is the lowest Sally will ever go, then it is rational for Burt to accept immediately: the most he will get is the remainder from the gains to trade, \$26.79.**
- Is it rational for Sally to start with \$73.21?**
- If Sally believes that Burt believes that Sally will not settle for less, then Yes.**
- But we can't predict the price.**

Bargaining power.

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How much bargaining power does each of the bargainers have?

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What determines the bargainers' beliefs (or expectations) about their rivals' thinking?

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Stage 1:

- Mortimer offers Hotspur an amount $\$x$ of the \$100. Then
- *either* Hotspur accepts $\$x$, and Mortimer receives the remainder of the \$100, and the game ends;
- *or* Hotspur rejects $\$x$, and the game continues to . . .

Mortimer and Hotspur

Stage 2:

- The sum to be divided has now shrunk to \$90.
- Hotspur offers Mortimer an amount $\$y$ of the \$90. Then
- *either* Mortimer accepts $\$y$ and Hotspur gets the remainder ($\$90 - y$);
- *or* Mortimer rejects $\$y$, and each receives nothing and the game ends.

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What will Mortimer offer $\$x$ at the first stage?

What is the least Mortimer can induce Hotspur to accept?

The other's shoes.

Mortimer puts himself in Hotspur's shoes, and imagines that the game has reached the second period. Hotspur is now in a strong position. Why? What will Hotspur propose for division of the \$90?

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∴ from the perspective of the first stage, Mortimer can predict what Hotspur will do.

Mortimer knows that Hotspur knows that Hotspur can assure himself of (close to) \$90 if he, Hotspur, rejects Mortimer's first-stage offer.

∴ Mortimer knows that the least Hotspur will accept in the first round is \$90; the best Mortimer can do is demand \$10 for himself.

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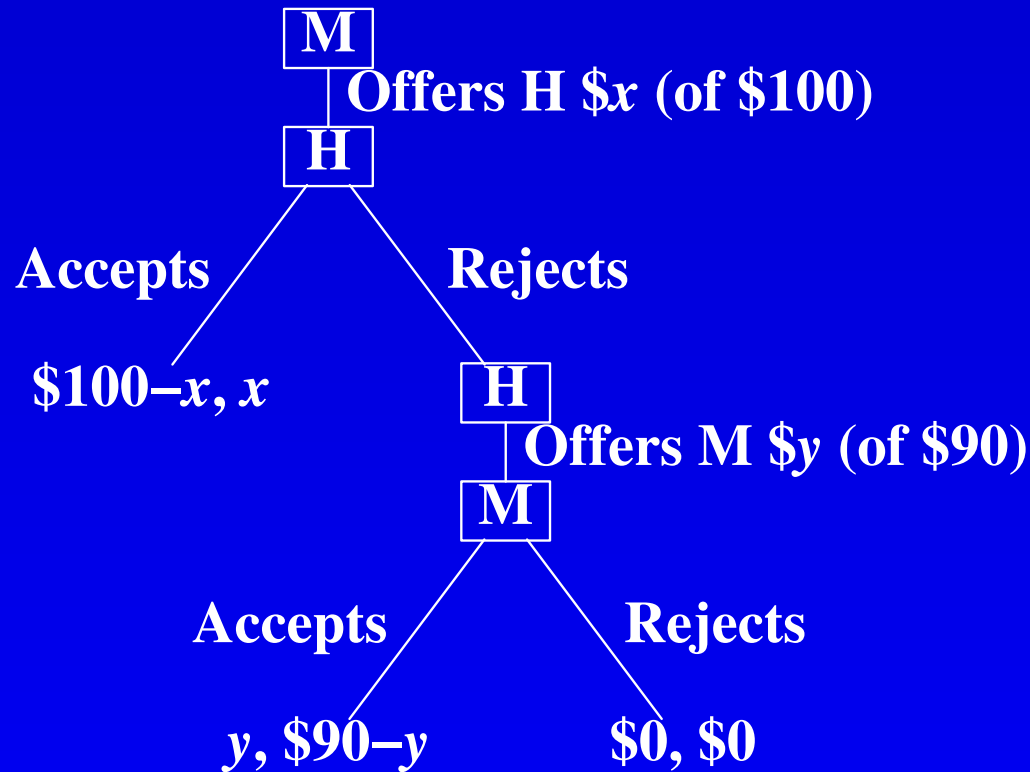
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Good bargainers:

- look several moves ahead, by putting themselves in the other's shoes.
- Each bargainer thinks through the other's rational responses to all possible contingencies.

Negotiation with a Deadline



An extensive-form, sequential game (M, H).

What does M. believe?

Introduce: putting oneself in the other's shoes,
second-mover advantage, reputation.

2. Forming Beliefs

2.1 Fallback Positions (BATNAs)

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The answer will depend on the *fallback positions* of the negotiators: the more attractive a bargainer's alternative opportunities, the better the negotiated outcome for that bargainer.

Sometimes known as BATNAs: *Best Alternative To a Negotiated Agreement.*

The alternative opportunities affect each bargainer's beliefs of what the other will settle for.

Example: credibility.

e.g. If Sally has a firm offer from someone else of \$1040, and if Burt knows of an equally good car available for \$1090, and if each knows of the other's alternative fallback, then the effective gains from trade are now \$50 instead of \$100.

The alternative opportunities have reduced the range to be bargained over, and the shrinkage has been asymmetric: the range of possible agreements has moved in Sally's favour, reflecting the fact that her fallback is more attractive than Burt's.

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The *credibility* of the bargaining positions is key.

A lower price?

It is credible to Sally that Burt will hold out for a lower price when:

- **either Sally knows that Burt has a tempting alternative opportunity (or BATNA), or**
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Search for better BATNAs:

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- **seeking alternative potential negotiating partners, or**
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Even if none of the potential alternatives (or BATNAs) is directly used, their existence can improve your negotiating position.

A good fallback.

Developing competing negotiating partners is a good fallback.

Since your bargaining power is inversely related to how good your opponent's BATNAs are, it's very valuable to know these; an aggressive bargainer might even try to worsen his opponent's BATNAs.

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e.g. coal & Japan

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2.2 Costs of Delay

As well as the bargainers' alternative opportunities (or BATNAs), the *relative cost of delay* of the bargainers is a determinant of their bargaining powers. *Time is money.*



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- Sally is forgoing interest on the proceeds from the sale;
- Burt is paying taxi fares or car rental bills until he has a car.
- In a strike, workers forgo their wages and the firm forgoes profits and market share: what's the size of the union's strike fund, the level of the firm's inventories, its alternative production facilities?

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Patient bargainers benefit.

e.g. Hotspur and Mortimer?

- Can you increase your opponent's impatience?
- Can you reduce your own by taking actions beforehand?

3. Focal Points

Often there are many possible points of agreement. Sally and Burt bargain over the \$100 with no alternative opportunities and no cost of delay, but a fixed deadline from outside: if there is no agreement by the deadline, then neither bargainer gets anything.

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Agreement is reached when bargainers' expectations converge:
when they share mutually consistent beliefs about what the other will agree to.

Focus?

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Focal points are vague. Possible determinants of focal points: (think of the Battle of the Sexes)

- precedent (always here before)**
- convention (take turns)**
- arithmetical symmetry (fifty-fifty)**
- suggestion from an impartial party**

Experimental data.

Bargaining experiments: bargainers are anonymous and given the same number of tokens each, which have have different values for each of the bargainers.

Reveal the marked tendency for settlement on a nominal 50–50 split, even though the values of the tokens are arbitrary → the value split was seldom 50–50.

Absent a unique bargaining equilibrium, a powerful tendency to settle for “equal shares”, although *equal's* definition seems not to matter much, so long as there is a commonly agreed way of keeping score.

No agreement (i.e. inefficient) in about 20% of the experiments: surprisingly high?

Lessons?

Conclude: exact, true division of the “pie” is less important to the negotiators than the fact that the negotiations don’t break down: any division better than none.

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Conclusion: good strategy to look for some way to define a focal point on which agreement can coalesce, thus avoiding breakdown.

4. Commitment

One of the bargainers manipulates his/her rival's expectations.

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e.g. Suppose Sally, making the first offer, announces that Burt must take or leave her offer, saying that if Burt rejects her offer she will refuse to bargain further and neither will get the \$100.

Sally is able to convince Burt she means it.

What does she demand?

All of the \$100 minus a few cents.

Faced with a choice of nothing or some cents, Burt accedes rationally.

The importance of commitment.

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Good to have flexibility *before* negotiations begin, but to be inflexible *during* the negotiation.

Partial commitment and partial pregnancy?

Commitment must be all or nothing.

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If Burt believes that Sally might be willing to bargain (if no agreement is in sight, say), then it's not rational for Burt to accept the pittance offered.

If Burt replies with a counter-offer, then Sally's situation has changed: she's now faced with zip if she persists with her threat, or some share of \$100 if she bargains.

After the deed, it's in Sally's interest to renege, but the ability to renege eliminates the gains from commitment.

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Sally's move is a *strategic move*, and must be credible, lest it is ineffective.

Credible commitments?

See the eight-fold path to credibility in Theme B:

- 1. Reputation**
- 2. Contracts**
- 3. Cutting off communication**
- 4. Burning your bridges**
- 5. Leaving outcome beyond your control**
- 6. Moving in steps**
- 7. Teamwork**
- 8. Mandated negotiating agents**

Further considerations.

Preempt your opponent's commitments: leave him an escape route, literally or metaphorically.

Check how firm your opponent's commitment is: are prices subject to negotiation?

If both negotiators have the power to commit, they may commit to incompatible demands.

Commitment is risky: possible high payoff, possible lack of agreement.

e.g. General Electric's take-it-or-leave-it offer led to union counter-responses.

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If you can commit and your opponent can't, then commit before negotiations begin so as to receive most of the gains from trade.

5. A New Negotiation Tool: Settlement Escrows

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Here's how they work:



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Here's how they work:

- Burt and Sally agree to a neutral mediator.
- Sally tells the mediator, in private, a price at which she'd be willing to sell.
- Likewise, Burt lets the mediator know, also in private, a price at which he'd be willing to buy.

Settlement Escrows

- **The mediator checks whether the two prices cross: whether Burt's offer exceeds Sally's bid:**
 - **Yes: the mediator calculates the midpoint price, which Sally and Burt have already agree in advance to would be their transaction price.**
 - **No: the mediator doesn't reveal either price, announcing only that the prices didn't cross. Neither side learns the other's bid, and the two parties can go on negotiating without prejudice.**

How does S.E. work?

Why does Settlement Escrow allow you to be much more honest without getting burnt?

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Why does Settlement Escrow allow you to be much more honest without getting burnt?

Let's take a case where Sally is truly willing to sell the item at \$120, but she doesn't want to give it away at \$120 if Burt is willing to pay much more.

Under the new scheme, it's now much safer for Sally to ask for \$120:

- If Burt asks for a price above \$120 (say, \$160), then the deal is done at the midway price (\$140), which fine by Sally, who gets more than she asked for.**

And while Burt now knows Sally asked for \$120, and may be kicking himself for not inputting a lower price, it's too late for him to do anything about it. The game is over. Those are the rules. As the seller, Sally is protected.

Thinking it through.

- **What if Burt asks for a price below \$120, say \$110? Then the deal doesn't go through.**

True, Sally and Burt will have to try some other way to reach an agreement. But in making a reasonable opening demand, Sally hasn't compromised her position in any subsequent negotiations.

All the go-between reveals is that the prices didn't cross.

Burt knows that Sally asked for a price above \$110, but that's all he knows.

Since Burt doesn't have the information he'd need to box Sally in, she is still protected.

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When the parties in a negotiation feel safe enough to make reasonable demands, they're much more likely to reach an agreement.

There's a much better chance that whenever there's a mutually beneficial deal to be made, it will be made.

Origins of Settlement Escrows.

Settlement Escrows conceived of as an aid to pretrial negotiations: you may be willing to pay \$100,000 to settle the matter, but you may not want the other side to know that — unless it's willing to settle here and now. If it isn't, revealing the fact that you're willing to settle for \$100,000 may be what tips the other side into deciding to go to court rather than to continue negotiations.

The solution is for both parties to agree, at the outset, to use a settlement escrow.

Applications.

Settlement Escrows could be used in a wide range of situations:

- to settle on the sale price of a house,**
- to agree on an employee's salary,**
- to agree on the price of a parcel of land,**
- to agree on the price of a patent.**

The employee might be willing to work for very little, the landholder anxious to sell, or the inventor keen to see his idea commercialized, but none wants to tip their hands, either.

In all these cases, use of a settlement escrow would maintain a veil over the negotiations, allowing both parties to negotiate in good faith.

6. Summary of Bargaining

Bargaining: coordinating bargainers' expectations.

Internal logic: fallback options and impatience.

Outside forces.

Arithmetical symmetry of the 50–50 split a focal point.

Ability to commit strengthens one's bargaining position.

Look forward and reason back.

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- 3. Estimate your and your opponent's degrees of impatience and costs of waiting: if his is higher than yours, you have an edge.**
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- 2. The relatively more attractive your fallback alternatives (or BATNAs) to agreement, the better your outcome: invest in development of alternatives.**
- 3. Estimate your and your opponent's degrees of impatience and costs of waiting: if his is higher than yours, you have an edge.**
- 4. Find a way of defining a focal point which benefits you, using phony precision if necessary, especially if there is a deadline for agreement.**

Threefold Summary

More generally:

- **Know yourself**
- **Know the other(s)**
- **Know the situation.**

(See Murnighan in the Folder.)